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From Main Street Inflation to Wall Street Inflation

"Still inflation did not even come in sight. As pointed out, the only inflation this generation has experienced in the United States was in the 1920s when the budgets showed surpluses and even the price level remained singularly stable. The huge inflation of credit at that time, engendered not by the government but by private banks for unprecedented speculative excesses, remained hidden behind a vast reduction in costs (thanks to a spurt in technical progress) which inflated profits with the volume of business with stable prices."

The Age of Fable
Gustav Stolper, 1942

As the evidence of a global economic slowdown grows more pronounced, the global financial markets grow progressively more bullish. As always, Wall Street leads the speculative parade. Boosted by the prospects for still lower inflation and interest rates, the Dow has pierced the magical 5,000 barrier. Surely, the bullish consensus cries, 6,000 – if not 7,000 or 8,000 – cannot be far away.

We certainly share the general expectations of economic sluggishness. But, we see far more serious risks than does the complacent consensus. It appears to us that growth is faltering everywhere. If we are correct, and the global recovery is dying, it will have proven the weakest cyclical expansion of the entire post-war era. We see no reason to celebrate this fact.

Indeed, the emphasis now put on declining rates of inflation in consumer and producer prices appears to us entirely misplaced. Careful analysis leads to us to conclude that inflation has merely migrated from goods and services to financial assets. While this phenomena is generally overlooked or misunderstood today, it was well known to the classical economists, who rightly viewed it as a destructive and distorting force. Speculative excesses generated by financial-asset inflation can end in only one way – in savage asset-price deflation.

Our views clearly are not in accord with those who accept the consensus view that Federal Reserve policy remains tightly restrictive. How, they may ask, can inflation of any kind pose a threat, given the sharp contraction in the narrow monetary aggregates, such as M1 and bank reserves, that are widely viewed as proxies for Fed policy?

As we explain, structural changes in the U.S. economy and its financial system are confounding the traditional indicators. Some of these changes, such as the explosion in borrowing and lending outside of the banking system associated with a flight out of money balances and into securities, we have described in detail in past letters. This month, we add another: the growth of so-called "sweep" programs, which allow U.S. banks essentially to cheat on their reserve requirements on a grand scale.

The truth, as we show here, is that Fed policy remains quite lax. Certainly, there is not a shred of evidence that declining reserves or transaction deposits have imposed any restraint on bank lending. Massive leveraged speculation in the bond market, and record levels of margin debt in the stock market, also repudiate any alleged Fed tightness.

Yet real economies continue to founder. In part, this reflects monetary stringency in Japan, where repeated rate cuts have failed to revive bank lending. But more generally, it is a sign of how years of overconsumption and underinvestment have taken their toll, particularly in the Anglo-Saxon countries. Ironically, past consumption excesses now make for stagnant incomes and sluggish demand, keeping inflation in goods and services in check.

THE CREDIT EXPLOSION

It has become the great theme in the U.S. financial markets that inflation is dead, insuring bullish conditions for stocks and bonds for as far as the eye can see. We agree that among the industrial countries a serious escalation of consumer and producer price inflation is not in the cards, at least not for the foreseeable future.

What we challenge, however, is the complacent prevailing view that attributes this apparently secular downturn of inflation to a strong new commitment from both governments and central banks to hold inflation in check by keeping a tighter reign on credit and money than in the past.

The truth is that global credit expansion – or more correctly, credit inflation – is more rampant today than ever before. Since 1980, the supposed beginning of this new era of disinflation, the total stock of financial assets, overwhelmingly debt instruments, has increased two-and-a-half times faster than GDP in the rich industrial economies.

Compared to economic activity – that is, relative to GDP growth – credit has never been more abundant. The novelty is that this surge in credit creation hasn't fueled inflation in the prices of goods and services. Indeed, inflation rates for these items have declined sharply.

In the United States, total outstanding nonfinancial debt has more than tripled since 1980, from $3.9 trillion to $13.5 trillion. In absolute terms, debt growth of $9.6 trillion has contrasted with simultaneous nominal GDP growth of $4.32 trillion. From the end of 1989 to mid-1995, GDP growth of $1.77 trillion was matched by nonfinancial debt growth of $3.32 trillion. And these figures do not include the trillions of dollars borrowed and lent for speculation in the domestic and international money markets.

Clearly, it is not any kind of restraint on borrowing and lending that has brought CPI and PPI inflation down. What did, then? Well, both owned or borrowed money can be spent in three ways: on domestic goods and services, on imported goods, or on foreign or domestic assets.

Today, most economists focus on consumer and producer prices as the crucial measure of underlying inflation. The relative softness of these prices is taken as evidence of a restrictive monetary policy and an absence of inflationary pressures. But given the abundance of credit, this makes no sense. What should be scrutinized are the reasons why the traditional link between booming credit and inflation in goods and services has broken down.

Closer examination reveals dramatic changes over the past decade in the creation and direction of the flows of loanable and investible funds. These are:

- An explosive increase in the supply of these funds relative to overall economic activity, as measured by nominal GDP growth.
- A drastic diversion of money and credit flows away from goods and services and towards financial assets, and in some countries also towards imported goods, as reflected in soaring trade deficits.
- A massive shift on the part of private households out of their stock of liquid money balances and into marketable securities.
- Rampant, heavily leveraged financial speculation.

Together, these flows add up to compelling evidence of loose, even extremely loose monetary policies. Rampant price inflation is there to see, but it has shifted from goods and services to the markets for financial assets. Or, to express it in American terms – inflation has moved from Main Street to Wall Street.

Global Capital Market Trends

Equities
Selected Markets, % Change

Country (November 27)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	4.2%	12.8%	13.0%	-0.4%	18.3%
Canada	7.5%	10.6%	13.7%	-1.1%	16.8%
France	8.5%	0.5%	2.9%	-6.3%	9.8%
Germany	6.3%	6.2%	9.1%	-3.4%	17.1%
Hong Kong	-1.6%	16.3%	10.0%	-5.1%	36.7%
Japan	7.0%	-6.0%	- 0.7%	- 6.1%	28.0%
Mexico	13.8%	7.5%	0.3%	-2.6%	76.5%
Spain	9.3%	13.8%	6.6%	-0.8%	10.2%
U.K.	4.3%	19.0%	20.3%	0.0%	24.0%
U.S.	3.7%	30.9%	33.0%	0.0%	35.0%

Ten-Year Bond Yields
Selected Markets, Basis Point Change

Country (November 27)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	8.21	-43	-178	-216	-235	0
Canada	7.34	-51	-180	-178	-234	0
France	6.82	-50	-145	-110	-157	0
Germany	6.23	-27	-139	-108	-152	0
Japan	2.88	-11	-169-	181	-184	28
Spain	10.21	-72	-163	-88	-235	0
U.K.	7.53	-56	-118	-85	-128	0
U.S.	5.88	-16	-194	-200	-205	0

Exchange Rates
Versus U.S. Dollar, % Change

Country (November 27)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.34	1.4%	-4.1%	-2.5%	-4.5%	4.8%
Canada ($)	1.35	0.8%	3.4%	1.8%	5.0%	-1.7%
France (*f*)	4.94	-0.8%	7.5%	8.2%	-3.8%	9.6%
Germany (DM)	1.44	-2.1%	7.2%	8.2%	-6.3%	9.1%
Japan (¥)	101.86	-0.2%	-2.3%	-3.2%	-26.3%	2.6%
Spain (Pt)	122.26	0.0%	7.1%	6.6%	-3.4%	8.9%
U.K. (£)	1.55	-1.6%	-0.8%	-0.7%	-5.4%	1.2%

ASSET PRICE INFLATION

Actually, such asset-price bubbles developed in many countries for the first time during the second half of the 1980s. This happened against the background of a weakening world economy, falling consumer inflation and global monetary easing. The most pronounced cases were in Japan, the United States, Britain, Australia, Canada, New Zealand and the Nordic countries of Europe. In continental Europe, asset bubbles occurred on a more moderate scale.

Owing to various country-specific factors, this first wave of asset inflation played out quite differently in the various countries. By far the worst case was in Japan. Besides being the most rampant of all the asset bubbles of the late 1980s, the Japanese bubble also extended with equal vigor across both equity and real estate markets.

In most other countries, in particular Britain, Australia, New Zealand, Canada and the Nordic countries, asset bubbles were largely confined to real estate. Only in the United States did the asset bubble also embrace both stock and real estate markets, although this occurred on a more modest scale than in Japan.

Every single one of these real-estate bubbles ultimately went bust. In the process, the collapse of highly inflated collateral values created huge losses for banks and investors alike. In the United States, in particular, the federal government was forced to bail out depositors of bankrupt banks and S&Ls on a grand scale.

But in general, it seems the calamities related to the real estate bubbles of the late 1980s since have been absorbed. The one disastrous exception in this regard is Japan.

UNDERPERFORMING ECONOMIES, OVERPERFORMING MARKETS

In his book, *The Alchemy of Finance*, George Soros writes: "Reading the record, it is striking how many calamities that I anticipated did not in fact materialize." Looking at the persistently booming financial markets, it is definitely true to say that bond and stock investors have never had it so good.

Nevertheless, in declaring an absence of calamities, one needs to make a strict distinction between the sense of well-being that pervades the financial markets, and the general malaise of the real economies. The

truth conveniently neglected, if not ignored, is that the two have completely decoupled. By historic standards, the financial markets are stridently overperforming, while the real economies, by the tally of long-term growth, are just as stridently underperforming, compared to previous expansions.

Despite the massive demand stimulus from German reunification, the economies of OECD Europe in the first half of the 1990s have registered an unusually poor average annual growth rate of barely 2%, associated with sharply rising unemployment. Overall, U.S. economic growth has been somewhat better, but still considerably below its historic average.

THE NEW SOURCE OF BUSINESS PROFITS

All the more astonishing in the light of this subpar economic growth has been the fact that business profits in general have performed extremely well. Yet, though widely at record levels, soaring profits everywhere have failed to stimulate strong investment. In many countries, it has become the established pattern that businesses invest little – often no more than can be financed out of their current cash flow from depreciation and retained profits. New corporate borrowings are used primarily to finance acquisitions or temporary surges in inventories.

Obviously, businesses have discovered a new method for raising their profits. In the United States, with trade union power now smashed, the biggest marker has been the relentless downward pressure on real wages for the majority of Americans, as wage rates have failed to keep pace with even modest productivity gains. As labor has remained relatively cheap, this has fostered labor-intensive economic growth. Employment in the United States today is more than 60% higher than in 1970.

In Europe, where powerful trade unions continue to permanently boost the price of labor, businesses keep their wage bills under control mainly through labor shedding and labor-saving investment. The resulting high real wages benefit a declining share of the European labor force. Many low-paying jobs have disappeared forever, generating double-digit and ever-rising unemployment.

The net result, both in the United States and in Europe, has been a decline in living standards. But this has manifested itself in two different ways: In the United States, it is visible in sinking real wage rates. In Europe, by contrast, it appears through rising unemployment. The common, fundamental cause of both dismal trends is the fact that overall capital formation is no longer sufficient to allow for full employment at present wage levels.

For years and years, these letters have denounced the fiscal and monetary excesses with which the leading industrial governments and central banks have ravaged the health and viability of our economies. Have these all been just false alarms, considering today's ever-bullish financial markets and ever-falling inflation rates?

FROM CAPITAL ACCUMULATION TO CAPITAL CONSUMPTION

No, the alarms have not been false. Grievous, lasting damage has been done to the warp and woof of our economies, and thus to their future growth. Everywhere, though in some countries more than in others, protracted borrowing and spending binges by governments and consumers have boosted these two demand components at the expense of savings and investment. In many cases, and particularly in America, the result also has been huge trade deficits and soaring foreign indebtedness.

Among the classical economists, it used to be conventional wisdom that such shortcuts to higher living standards – crowding out investment and running rising foreign debts – are the road to slow growth and impoverishment in the longer run. Ludwig von Mises described the process sarcastically: "It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises."

The sad fact of the matter is that in much of the industrialized world, capital consumption, not capital accumulation, has become a way of life, fueling a virtual debt explosion. The plain symptoms of such a capital consumption process are shrinking savings and investment ratios. Stagnating or sinking living standards are the ultimate effects.

The two tables shown here highlight the severity of this capital consumption process in the major industrial countries and the associated downtrend in living standards, as measured by the growth rates of real GDP per employed person.

Gross National Savings as a Percentage of GDP

Country	1980	1993
United States	19.8%	14.9%
Japan	31.1%	32.5%
Germany	21.7%	19.9%
France	23.6%	18.7%
Italy	24.7%	18.0%
Britain	17.7%	12.7%
Canada	22.9%	13.3%

Source: OECD

Real GDP Growth Per Employed Person

Average annual percentage change

Period	12 EC Countries	United States
1961-70	4.6%	1.9%
1971-80	2.7%	0.6%
1981-90	1.9%	0.8%
1991-95	2.0%	1.0%

Source: European Commission

Lately there is much talk that governments and central banks have smoothed out the business cycle with their smart policies. It may appear that way. But closer examination reveals they have done so by pillaging the savings and investment flows that dominated past business cycles. These flows were an inherent source of cyclical instability. But they also begat the kind of strong, dynamic growth that once created an abundance of jobs with high productivity and high wages.

The point to see is that in the end we have been left with enfeebled economies that inherently tend towards sluggish growth. The counterpart to this subdued secular growth is equally subdued secular inflation, which, in turn, predisposes a monetary policy of preponderant looseness.

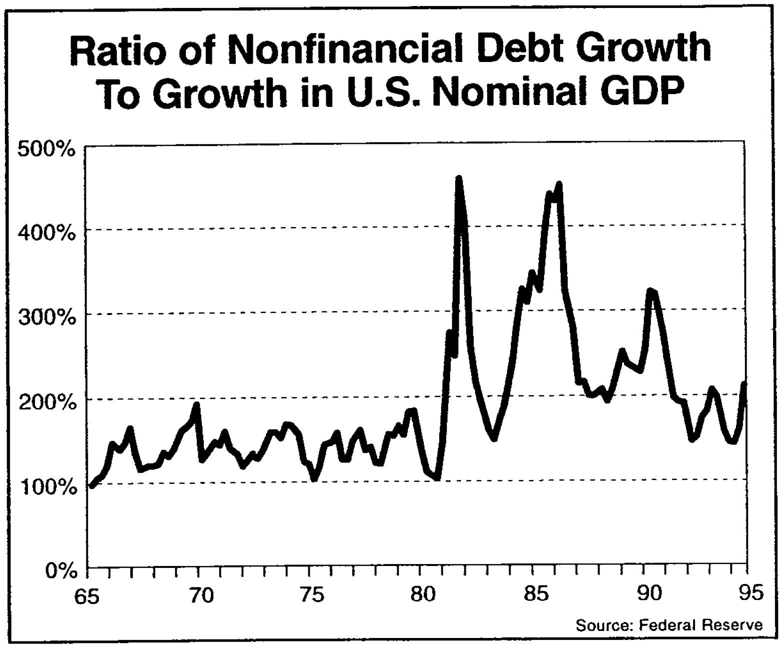
It literally is true that past consumption excesses, public and private, are producing lower inflation now by breaking the expansionary thrust of our economies. In essence, it is the typical boom-bust pattern. The obvious worst case in this respect is Japan, where the runaway asset inflation of the late 1980s ended in savage deflation.

However, we hasten to add that behind this global, secular decline of conventional inflation rates are two other factors of crucial importance. One is the fact that slower economic growth has moderated wage rises. The other is that excess demand in the traditionally inflation-prone countries increasingly has tended to spill over into soaring imports, rather than into price inflation.

We started this letter by pointing to the persistent, pronounced contrast between underperforming real economies and overperforming financial markets. In doing this, we had one question foremost in our minds: Is there a casual connection behind the two? Our answer is an unreserved yes, and it is easy enough to see why.

We discern one main reason for this extraordinary dichotomy: Our debilitated and maladjusted economies have been left increasingly less responsive to monetary stimulation. Just as a drug addict over time requires ever bigger doses of his favorite narcotic, so do our enfeebled economies now need larger and larger injections of credit to keep growing. But financial markets, not the real economies, end up attracting most of this newly created money.

Looking for specific reasons behind this redirection of money and credit flows, we see one cause of overwhelming importance. It concerns the uses to which the great bulk of today's borrowing and lending is devoted: consumer spending, government spending, financial speculation, corporate acquisitions, interest-rate payments, etc. These all have two things in common: They finance spending that first, is generally unproductive, and second, has either quite limited effects or none at all on real economic growth.



Above all, the "Ponzi game" of borrowing new money to pay the interest on old debt undoubtedly is a main factor behind the skyrocketing growth of the debt aggregates. While productive credit normally pays for its own debt service, unproductive debt essentially leads to an exponential rise in indebtedness, as interest costs compound. To maintain living standards, consumers must accumulate more and more debt. The ultimate recipients of these payments are the wealthy people who invest their increased incomes in financial assets – that is to say, in the debts of those who are forced to borrow.

THE U.S. MONETARY RIDDLE . . .

Pointing to the sharp downturn in the growth of the monetary base (currency plus bank reserves) and narrow money (M1), quite a few commentators are spinning yarns about impending monetary deflation in the United States. At the very least, the downtrend of virtually all the narrow money aggregates is widely interpreted as evidence of a restrictive monetary stance. The consensus conclusion is that the Fed soon will have to loosen its overly restrictive monetary policy with an extended series of cuts in the federal funds rate, fueling yet another bond and stock rally.

The only snag in this cozy assumption is that the bond market, acting ever faster, seems to have anticipated every bit of imaginable Fed easing, considering that yields on Treasury maturities up to five years already have plummeted below the current federal funds rate target, compared to the more normal liquidity risk premium of 75 to 100 basis points above fed funds. Once again, the U.S. bond market is proving its superlative proclivity to speculation.

. . . AND ITS PUZZLING JAPANESE COUNTERPART

No less confusing than U.S. monetary data are, at the first blush, their Japanese counterparts. For months now, many Japan experts have trumpeted that the Bank of Japan is wildly reflating, furiously pumping liquidity into the economy through open-market bond purchases and unsterilized, massive interventions in support of the U.S. dollar.

The general, rosy conclusion has been that this change in BoJ policy has created a wall of money that soon will swamp world financial markets, further buoying stock and bond prices as well as the dollar. Yet in many quarters, the Bank of Japan still is accused of being too tight. Even more money pumping is thought to be needed.

Ever since this story about the Japanese "wall of money" began to circulate, we have disputed it. What we saw and continue to see in Japan are interest rates that have been slashed to the bone and heavy bond

purchases by the central bank. The BoJ has flooded the banks with excess reserves. Yet these actions so far have had virtually no effect on money and credit.

Reading many reports about the improving monetary situation in Japan, we notice one common, crucial fallacy: an excessive focus on the actions of the Bank of Japan, and far too little recognition that its easing measures have had absolutely no follow-through in the banking system.

CENTRAL BANKS PROPOSE, BUT BANKS DISPOSE

It seems necessary to make one point crystal clear: Central banks mainly act upon markets and economies through the medium of the banking system. Whether or not the easing measures of a central bank become truly effective depends entirely on the response of the banks and the financial system as a whole. The ultimate creators of money are the commercial banks.

Strictly speaking, central banks determine directly only two monetary variables: the aggregate level of bank reserves, and the money market rate. Unless banks translate these impulses into credit and money creation of their own, central bank easing just goes up in smoke. So to say, the central banks propose, but the banks dispose.

The popular belief that central banks can simply print money is a complete misconception. In our credit-based economies, there is only one way to create money – in other words, to create liquidity – and that is by expanding bank credit. But in Japan, total bank assets and liabilities are no higher today than there were one or even two years ago. There have been some shifts within the totals, but overall there has been literal stagnation. Nor, by the way, do the most recent figures show any traces of life. Like the Fed in 1929-93, the Bank of Japan is "pushing on a string," to use the familiar metaphor.

To get the essence of it, it is most instructive to compare the monetary scenarios in Japan and the United States. They are at the exact, opposite extremes. If Japanese monetary policy looks very loose in terms of bank reserves and interest rates, U.S. monetary policy appears by the same measures highly restrictive. Bank reserves, narrow money (M1) and the monetary base are declining or are very weak by past standards. However, in terms of bank lending, it's an entirely different story. In Japan, bank lending is stagnant, while in the United States lending has been running wild.

We have conducted this painstaking analysis in order to expose the fallacy of the consensus view that Japanese money is loose and U.S. money is tight. These two gross misconceptions underlie the perennial false forecasts of a strengthening dollar and a weakening yen. Here is a brief example from a recent report by a British brokerage house that reputedly ranks as a leading source of institutional expertise on Japan:

"Fundamentals have indubitably already turned in favor of the dollar: The BoJ is being forced by a historic slump in nominal GDP growth to inject liquidity into the economy. Given the continued tight stance of the Fed (as measured in terms of quantity of liquidity injections), based on the assessment that the U.S. economy is not slowing strongly, the balance of money creation in Japan relative to that in the United States is shifting. With fewer dollars being printed by the Fed, but more yen being put into circulation by the BoJ, the forex market is likely to switch in (the second half of calendar year 1995)."

The very same misconception – that an era of excess liquidity is unfolding in Japan – has been implicit in the generally bullish forecasts of American and British brokers for the Japanese stock market. In reality, any bullishness that has temporarily existed on the Tokyo exchange has come from heavy buying by foreign investors. Liquidity-strapped domestic investors have been, and remain, net sellers.

The fact is that all of the BoJ's easing measures so far have been utterly ineffective in stimulating the Japanese financial system and economy. Japanese institutions remain trapped in a vicious spiral of asset deflation that destroys liquidity by destroying collateral values. The charge commonly levied by foreign observ-

ers is that the BoJ is not doing nearly enough to combat this state of affairs and should simply "print money" *à outrance*. Underlying this view is the axiom of the American monetarists – that central banks have the power to "reflate" at will.

All this talk reveals an unbelievable ignorance of monetary matters. After careful scrutiny of the relevant facts, we've come to the conclusion that the Bank of Japan has done all that it can do. It has deluged the banking system with excess reserves – current bank reserves amount to more than twice the required levels – and it has slashed its call money rate to 0.3%.

What more can the BoJ reasonably be expected to do? In theory, it could buy still more government bonds, putting the banking system under the pressure of ever higher, non-interest bearing cash balances. Under normal conditions, such excess reserves provide the leverage by which central banks can tend to drive banks into lending. But with Japanese money market rates near zero, this lever has little force.

In theory, a more aggressive open-market policy would push the overnight rate still lower. But a bare 0.3%, we think, is already as low as it can reasonably get. A lower rate would only make for a ridiculous reading, while adding little or nothing to the effectiveness of monetary policy.

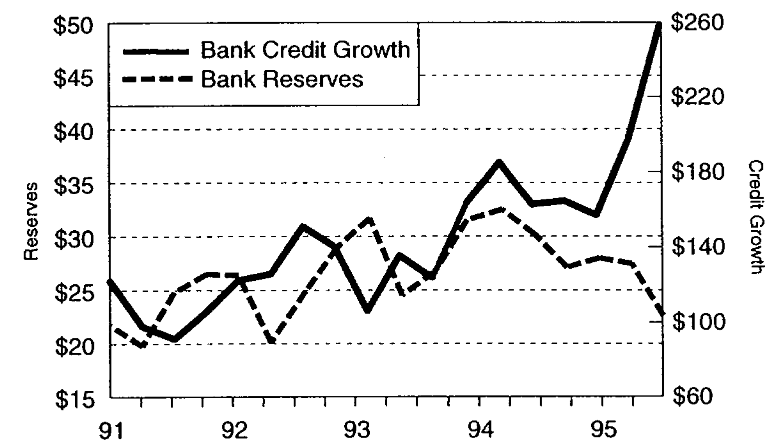
BANK CHEATING, NOT FED TIGHTENING

If Japanese banks are sitting on huge excess reserves, U.S. banks are faced with sinking reserves. Why then do we regard this as a misleading sign of monetary tightness? For two reasons: First, the ongoing U.S. lending binge belies the existence of any credit restraint. Secondly, the decline of bank reserves primarily results from shrinking reserve requirements. The odd cause of this – the growth of so-called "sweep programs" – is well known in the markets.

A recent innovation of U.S. banks, sweep programs ensure that only a bare minimum of transaction dollars are subject to reserve requirements. A bank offering such a program automatically "sweeps" outstanding balances in large checking accounts overnight into savings-type accounts that have no reserve requirements.

The banks benefit by avoiding the 10% marginal reserve requirement on transactions balances. Or, to put it less politely: They are cheating massively on their reserve requirements. A sweep program can reduce a bank's daily average deposit levels and associated reserve requirements by 50% or more.

Year-Over-Year Growth in Bank Credit Vs. Total Bank Reserves, in Billions of $



Source: Federal Reserve

The rapid expansion of sweep programs is well known to the financial community and of course to the Fed. Yet in public discussion, it is conveniently ignored that these programs essentially make a mockery of the monetary aggregates involved (M1, bank reserves and the monetary base) as measures of the Fed's stance. Nonetheless, the extraordinary weakness of these aggregates is widely cited as evidence of Fed tightening. We sometimes wonder: What is ignorance, and what is dishonesty?

To keep the Fed funds rate at its targeted level – presently 5.75% – the Fed has to siphon off the excess reserves that the banks create through their cheating. In other words, the Fed's actions merely adapt to sinking reserve requirements. This declining trend contrasts ludicrously with the banks' lending binge. Indeed, con-

tracting bank reserves have been anything but a limiting factor on the supply of credit. At their present level of $21 billion, the banks' reserve balances at the Fed – about 0.6% of total assets – are a *quantitite negligéable.*

As we've said, banks and the financial system as a whole ultimately decide the effectiveness of any monetary policy. A comparison of developments in Japan and the United States reveals a stunning contrast in this respect. In Japan, aggressive central bank easing has been thwarted by a virtually immobilized banking system, while U.S. banks, in the face of declining bank reserves and a sharp rise in the federal funds rate, still have pumped well over $400 billion of new credit into the U.S. economy and financial markets since early 1994.

WALL STREET LEADS THE SPECULATIVE RAMPAGE

Assessing the near-term outlook for economies, financial markets and currencies, the outstanding fact is that recent economic indicators, though still mixed, signal a sharper-than-expected slowdown in world growth. Is it only a pause, to be followed by a bounce back early next year? Or will it get worse? These are the critical questions.

Against the backdrop of weak economic data, economic expectations have taken a distinct turn for the worse in recent weeks. All around, growth forecasts are being revised downward. While this sluggish trend has come as a shock to many policymakers, business executives and to most consumers, the financial markets have celebrated with instant jumps in bond and stock prices. Investors and speculators alike are anticipating and discounting much lower interest rates in the United States and as well as a steady drop in global rates.

The singular star performer in both bonds and stocks this year has been Wall Street. Why is that? Is it because the U.S. economy and the U.S. financial markets have the best underlying fundamentals? Definitely not. Rather, it is because at all times Wall Street can be counted on to be in the forefront of any speculative rampage.

As Keynes wrote of Wall Street in the 1930s: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

That the United States, with its pitiable supply of savings and its consumer debt binge, has the lowest long-term interest rates in the world, save for the special cases of Japan and Switzerland, is absurd. But considering Wall Street's unique capability for leveraged bond speculation, still further declines in bond yields wouldn't surprise us. Further rate cuts by the Fed are sure to send the yield-curve players on a new rampage. Everybody learned to play the game in 1993; many lost out in 1994. A growing army of speculators is determined to hit the jackpot this time.

This is what we observe presently on Wall Street: A fear of being left behind, once the Fed actually trims rates, has led to ever-earlier anticipatory buying. The portents are everywhere. Long-term Treasury yields are back to their lows of early 1994, when the federal funds rate was at 3%, while Treasury maturities out to five years are yielding less than the current 5.75% fed funds rate. Betting on substantial, future capital gains, speculators accept present, sizable interest-rate losses.

We fully agree with the near-term conclusions of the bullish consensus. But we diametrically disagree with the prevailing, rosy assessment of the causes behind the new bull run. In Wall Street's view, it is a healthy response to declining inflation and a corresponding decline in inflationary expectations. This is moonshine. Such a rapid move in a market as vast as the U.S. fixed-income market essentially suggests massive speculation.

BACK TO THE NEAR FUTURE

Apparently, the main question is this: How many rates cuts will the various central banks still deliver? The answer, of course, depends on how much more economic weakness we see in the United States and

Europe. We presume the slowdown will be more severe than generally expected. We have never shared the widespread euphoria about this cyclical recovery.

In terms of GDP growth, it has been the most anemic recovery in the postwar period for the major industrial countries. Low and falling inflation, though widely eulogized, is necessary but not sufficient for sustained, healthy growth. It should be remembered that the Great Depression of the 1930s was preceded by a decade of price stability.

In Europe, recovery actually started only in early 1993, driven primarily by inventory building and by fast-growing exports to the rest of the world. The demand component that has underperformed the most has been private consumption. During the three recovery years 1993-95, consumption demand in the European Community as a whole managed an unusually meager annual average growth rate of just 1%. Though investment also recovered, it also performed much weaker than in past cycles.

As for the U.S. recovery, its big positive has been a surge in business investment following more than eight years of stagnation. Its great negative has been a new, unsustainable consumer-borrowing spree. From the end of 1992 to mid-1995, personal income growth of $690 billion compared with personal debt growth of $812 billion.

There are many who try to give this new borrowing binge an air of sanity by arguing that its effects on household balance sheets have been more than matched by soaring financial asset values, leaving consumers on balance with rising net wealth. Well, that's precisely what the Japanese thought in the late 1980s, as they cheerfully enjoyed the marvelous, but temporary, wealth effects of exploding stock and real estate values.

No doubt, the Wall Street boom has been an important underpinning for the consumer borrowing binge. But to praise this as a token of financial health is more than shortsighted. It's a fool's paradise. Because these high-flying paper securities are not backed by real investment, they make for purely imaginary capital. To be sure, their owners feel richer, but for the real economy there is no gain at all, except more consumer borrowing and spending at the expense of savings. That is definitely a negative for economic growth in the long run. While the Japanese bubble mostly inflated unsustainable malinvestments, the U.S. bubble helps to finance unsustainable overconsumption.

A BUBBLE OR NOT A BUBBLE – THAT IS THE QUESTION

What is it that causes us to rate the Wall Street boom a bubble? Simply put, the financial boom flies in the face of the extreme paucity of new savings in the United States. The acid test of any bubble is the relationship between available savings and the total flow of funds into the markets. As we have repeatedly explained, the money pouring into the U.S. markets comes from various sources, but least of all from genuine savings. Most of it arises from two extraordinary sources: a race out of money into securities, and protracted credit creation vastly in excess of current income and GDP growth. The one makes for a money bubble; the other one for a credit bubble.

Every bubble is vulnerable to monetary tightening. But since we see loose U.S. money for as far as the eye can see, we have to ask ourselves what else could possibly prick these bubbles. Any unforeseeable event might do it. The implicit danger of any bubble is that it creates an illiquid – and therefore highly vulnerable – financial structure. In Japan, corporations were the ones who strangled themselves. In the United States, consumers have been the primary victims. Their liquidity is in a dramatic decline, and the decline is feeding on itself. We think the Fed, freed from external discipline by the foreign central banks who prop up the dollar, is desperate to keep the money and credit bubbles afloat forever with monetary looseness.

EUROSCLEROSIS REVISITED

If we are skeptical about the U.S. recovery, we are no less skeptical about its European counterpart. In most countries, GDP growth has been decelerating since early this year. The initial consensus conclusion was

that this must be merely a temporary slowdown, given the general, progressive monetary easing underway in most countries.

As already mentioned, the motors of recovery in Europe were inventory building and surging exports. Optimistic forecasts for 1995 assumed these demand boosts would, in the customary cyclical way, trigger an investment boom, bringing higher employment and income growth. This would support higher consumer spending. But it hasn't worked this time. Unexpected investment weakness has prevented domestic demand from taking over as the engine of growth. France, with its restrictive fiscal and monetary policies, appears to be in the worst position, followed by Germany, which is plagued by currency appreciation and wage increases in excess of productivity gains. European growth forecasts for 1995 have been progressively revised downward from an initial 3% to the present 2%.

There can be no question that this quick abortion of the economic recovery in Europe has more structural than cyclical causes. It reminds us vividly of the term "Eurosclerosis," coined in the 1980s, which became a label for slow economic growth in Europe compared to the Reagan boom in America. Back then, we strongly disputed the validity of this view, arguing the Reagan boom was excessively hooked on government and consumer debt, while European countries, in particular Germany, were exercising fiscal and monetary restraint. But since the mid-1980s the increasingly reckless expansion of the welfare state, combined with excessive wages rises, have turned Eurosclerosis into a reality, corroding Europe's long-term growth prospects.

Observing this trend, we have asked ourselves for some time whether it may not invalidate our central view of a chronically weak dollar and a secularly strong Deutsche mark. While U.S. economic growth is impaired by a monetary looseness that fuels asset inflation and private overconsumption, Europe has impaired its long-term economic growth potential with a fiscal looseness that has fueled public overconsumption.

The corrosion of European economic prospects weakens but doesn't reverse the bull case for the D-mark. The fundamental depressants weighing on the dollar are the gargantuan U.S. trade deficit and huge U.S. capital outflows. Both are the result of Fed laxity. In the long run, these two deficits are far too big to be accommodated by private foreign capital. Thus, dollar stability has become critically dependent on support by foreign central banks. If the Fed ever were forced to turn really tight in order to defend the dollar, it would prick the Wall Street bubble.

MEXICO TAKES A TURN FOR THE WORSE

We note with special interest the renewed deterioration of financial and economic conditions in Mexico. In our view, the speculative frenzy which pervaded Mexico's markets until last December's peso devaluation must be ranked among the worst excesses of the global bubble. Now, we see unfolding the inevitable deflationary aftermath.

It has been truthfully said that Mexico's problems differ from America's only in degree. As in the United States, over-consumption – financed by a debt – became a way of life for Mexico's middle class during the 1990s. While savings and investment rates fell, the current-account deficit soared, reaching $21 billion, or 7.8% of GDP, in 1994.

Most remarkable was Wall Street's eagerness to finance this consumption orgy in the face of truly disastrous economic fundamentals. Between 1990 and year-end 1994, almost $90 billion in foreign capital flowed into Mexico. Yet during that same period, Mexico's GDP, in dollar terms, *contracted* by some $6.5 billion. Even in peso terms, annual growth averaged just 2.6% in those years – hardly justifying the widespread bullish talk that painted Mexico as some Latin American version of the Asian Tiger countries.

No less stunning has been Wall Street's determination to repeat its errors. Within weeks of Mexico's near default in January, speculative inflows resumed – lured by the hope of quick profits, and reassured by the promise of $50 billion in U.S. and IMF loans. Forecasts of a strong Mexican recovery were widely aired, and widely believed.

Now reality is setting in. Mexico's debt burdens totally preclude a return to sustained economic growth. The country's latest borrowing binge, on top of the debt left over from the oil boom of the 1970s, has driven Mexico's external debt to staggering $170 billion. At today's devalued exchange rate, that equals a crushing 185% of GDP. Annual debt-service payments alone, including those to the U.S Treasury and the IMF, now exceed 20% of GDP.

As a result, the Bank of Mexico finds itself in the classic debtor's trap. To attract foreign capital, curb the chronic trade deficit, and defend the peso from speculative attack, the bank must impose a harsh monetary regime. Yet that same policy cripples the economic growth needed to reduce debt to a more manageable level. Only an export boom prevents an outright economic collapse. We can only wonder how Mexico will fare if, as we expect, the global recovery falters.

CONCLUSIONS

Both in Europe and in America the economic news looks increasingly soft, if not gloomy. The growth bulls are struggling to explain their reasons for expecting an acceleration next year. In our view, the recovery – the most anemic in living memory for the industrial countries – is over.

Focusing on the prospects for lower inflation and an obligatory monetary easing, the financial markets may well celebrate with another bout of bull speculation. But for the reasons explained earlier, we see more downside risks to economic growth than the complacent consensus. That's bad for public finances and for business profits.

The recent trend of a soft DM reflects anticipation of an imminent Bundesbank rate cut. Any move, in actual fact, is likely to have a very short-term effect. Over time, we expect far more easing from the Fed in response to slower U.S. economic growth. This, in addition to the huge U.S. payments gap, will undermine any dollar strength.

The dollar also has faltered against the yen. We see two fundamental causes: a credit deadlock in Japan, owing to a virtually frozen banking system, and a credit and money deluge in the United States. Japanese institutions continue to repatriate funds. Only the Bank of Japan prevents further dollar weakness.

We've described the unique features of the recent business cycle and the associated deluge of funds into the financial markets, and explained why they emerged. Although many structural economic and financial changes were responsible, the extreme speculative overshooting, in particular on Wall Street, couldn't have occurred without a very loose monetary stance. What could turn the markets? A collapsing dollar could and would. But, massive dollar purchases by foreign central banks appear to give the Fed freedom to ease at will.

Does this mean the bull market will last forever? It is in the nature of a rampant boom that almost anything can collapse it. However, two specific things eventually destroy even the most euphoric bubbles: a fantastic level of expectations, and extreme illiquidity effects. This doesn't exclude the possibility that this bubble will continue for some time. But the most important thing to see is that it inevitably will burst one day.

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DR. KURT RICHEBÄCHER, Publisher and Editor

Bill Montague, Associate Editor

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1129 E. Cliff Rd., Burnsville, Minnesota, USA 55337. Subscription orders may be placed toll free from inside the USA by calling (800) 894-3424. For all other inquiries, and to order from outside the USA, please call (612) 894-4088. Fax: (612) 895-5526. Subscription rates: North America, U.S. $400. Outside North America: U.S. $420, or DM 630. Published monthly.